

**Summary of Testimony of
Chairman Curt Hébert, Jr.
Federal Energy Regulatory Commission
before the
Subcommittee on Energy and Air Quality
of the Energy and Commerce Committee
United States House of Representatives**

February 28, 2001

The Commission's primary role in the natural gas industry is to ensure that adequate pipeline infrastructure is available to serve the growing demand for natural gas at just and reasonable rates. Since the Wellhead Decontrol Act of 1989, the Commission has had no jurisdiction over the prices charged by natural gas producers at the wellhead. The Commission retains only limited jurisdiction over certain sales for resale in interstate commerce. The Commission's primary jurisdiction is to: (1) authorize the construction of interstate pipeline transmission and storage facilities; and, (2) set the rates, terms, and conditions of service for interstate transportation and storage of natural gas.

Since wellhead decontrol and the Commission's open access transportation program, there has been a well-functioning, competitive market for the sale of the natural gas commodity. From the mid-1980s until this winter's heating season, competition among natural gas producers and marketers has resulted in readily available supplies at prices lower than during gas price regulation. This winter prices have risen primarily due to an imbalance between supply and demand. However, the current high prices provide the necessary market signal to producers for increased production, and producers have significantly increased their drilling activity. Although there is a time lag between increased drilling and a supply response, an increase in gas supplies should help moderate the recent price increases.

The Commission can help mitigate price increases by exercising its jurisdiction over the certification of new pipeline projects to ensure that newly developed supplies can reach the market quickly and where needed. Also, both the Commission and the states must eliminate current bottlenecks that limit the transportation of natural gas to areas where demand is highest. I will do everything I can to ensure that the Commission quickly processes certificate applications for pipeline projects that will meet these needs. To the extent these bottlenecks are within state jurisdiction, however, the states must similarly undertake to improve their infrastructure. I recognize the critical importance to your constituents, and to our country, of having an adequate natural gas transportation infrastructure.

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Mr. Chairman and Members of the Subcommittee:

Good Afternoon. I am Curt Hébert, Jr., Chairman of the Federal Energy Regulatory Commission (Commission). I am pleased to be invited to this hearing on natural gas issues and the role of natural gas in national energy policy.

In my testimony today, I would like to make three basic points. First, the Commission's statutory role in natural gas markets focuses principally on transportation, not commodity prices. The Natural Gas Wellhead Decontrol Act of 1989 completed the deregulation of the prices producers charge for gas sold at the wellhead in 1993. As a result, the Commission has no direct authority to regulate the prices charged by natural gas producers. The Commission retains only limited jurisdiction over certain sales for resale in interstate commerce. The Commission's primary natural gas jurisdiction is to: (1) authorize the construction of interstate pipeline transmission and storage facilities; and, (2) set the rates, terms, and conditions of service for interstate transportation and storage of natural gas. In short, our central role in the natural gas industry is to ensure

that adequate pipeline infrastructure is available to serve the growing demand for natural gas at just and reasonable rates, terms and conditions of service, and without undue discrimination.

Second, since wellhead decontrol and the Commission's open access transportation program, there has been a well-functioning, competitive market for the sale of the natural gas commodity. From the mid-1980s until this winter's heating season, competition among natural gas producers and others has resulted in readily available supplies at prices lower than during gas price regulation. This winter prices have risen because of an imbalance between supply and demand, due to a number of factors discussed later. However, the current high prices should provide the necessary market signal to producers to increase production. Already there are reports that producers have significantly increased drilling activity. Although there is a time lag between increased drilling and a supply response, the increase in gas supplies hopefully will, over the next several years, help moderate the recent price increases. As reported on Monday of this week, the futures contract price has dropped by about 50 percent, from almost \$10 an MMBtu (million Btu) earlier this winter to about \$5 an MMBtu (Gas Daily, "Bid week prices coast narrowly into weekend" February 26, 2001). While this is probably due to warmer weather and recent decreases in storage withdrawals, these are clear signs of a well-functioning market. I will not make any predictions about what prices will be in the future, but I firmly believe that allowing the competitive wellhead market to work is the best way to obtain adequate gas supplies at the lowest reasonable price.

Third, notwithstanding the fundamentally sound nature of the natural gas market, the Commission can help mitigate price increases by exercising its jurisdiction over the certification of new pipeline projects to ensure that newly developed supplies can reach the market. One of my top priorities as Chairman is to ensure that needed energy infrastructure is built. If increased gas supply is to help bring prices down, there must be adequate transportation facilities to move newly developed gas supplies to delivery markets. Also, current bottlenecks limiting the transportation of natural gas to areas where demand is highest must be eliminated. I will do everything in my power to ensure that the Commission quickly processes certificate applications for new pipeline projects that will meet these needs. To that end, Commission staff is looking at creative ways to expedite the processing of applications for new pipeline capacity to serve critical areas of the country. However, to the extent transportation bottlenecks are within state jurisdiction, the states must similarly undertake to improve their infrastructure. I assure you I recognize the critical importance to your constituents, and to our country, of having an adequate natural gas transportation infrastructure.

I will now turn to the specifics of these matters in greater detail.

I. The Federal Energy Regulatory Commission's Role in Natural Gas Markets

The Commission's role in the natural gas industry is largely defined by the Natural Gas Act of 1938. This Act gives the Commission authority to grant permission to construct new interstate natural gas pipelines and related facilities, such as storage and compression. It also authorizes the Commission to set the rates and terms of service for

the resale and transportation of natural gas in interstate commerce. Regulation of retail sales and local distribution of natural gas is a matter under State control, as is the production and gathering of natural gas. Controls on the wellhead price of natural gas, which the Commission previously regulated pursuant to a 1954 Supreme Court decision, were gradually phased out by the Congress. This started with the Natural Gas Policy Act of 1978, and culminated in the Natural Gas Wellhead Decontrol Act of 1989, which lifted all remaining wellhead price controls as of January 1, 1993. The Commission still retains jurisdiction over certain sales for resale in interstate commerce, but that jurisdiction now accounts for only a portion of the overall natural gas market. However, that jurisdiction is limited to sales for resale by interstate pipelines, intrastate pipelines, local distribution companies and their affiliates, unless the sales are from their own production or from sources where we have a free trade agreement such as Canada and Mexico. In 1993, the Commission authorized these sales to be made at negotiated, that is, market-based rates. Although the Commission, in limited circumstances, could amend the authorizations to provide for some other pricing method, I do not believe that this would provide effective relief to consumers, as sellers would find ways to move their supply to unregulated sales. Price controls on FERC jurisdictional resales would merely distort the market in the same way they prompted the industry to shift supplies from the interstate market to the intrastate market before the NGPA.

The Commission also authorizes natural gas pipeline siting and construction if found to be in the public convenience and necessity under section 7 of the Natural Gas

Act. Consideration of factors under the National Environmental Policy Act (NEPA), other appropriate statutes, and landowner interests must be taken into account before approving a natural gas pipeline project. In addition to its certificate jurisdiction, the Commission has authority, delegated by the Secretary of Energy, over the siting and construction of facilities for the import or export of natural gas under Section 3 of the Natural Gas Act, as well as authority under Executive Order No. 1045 to issue Presidential Permits for such facilities if they are located at an international border.

II. Competitive Natural Gas Commodity Markets

The oil embargo of the mid-1970s, coupled with heavy-handed price regulation by the Commission (then the Federal Power Commission), led to shortages and supply curtailments of natural gas in the interstate gas market in those years. In response to these critical supply shortages, Congress passed the Natural Gas Policy Act of 1978, which began the decontrol of natural gas commodity prices.

In 1985, the Commission required open-access, non-discriminatory transportation of non-pipeline natural gas across the U.S. natural gas pipeline grid. In 1989, the Congress enacted the Natural Gas Wellhead Decontrol Act of 1989, which ended all remaining wellhead price controls as of January 1, 1993. In 1992, the Commission took further steps to ensure a well-functioning natural gas market by requiring interstate natural gas pipelines to unbundle, or separate, their transportation service from their own sales service. That removed the opportunity for pipelines to discriminate in favor of their own "merchant" business by providing a higher quality transportation service as part of

their bundled transportation and sales service. Subsequently, pipelines exited the natural gas sales business completely and transferred their sales contracts to their marketing affiliates.

The Commission also established a program to permit holders of transportation capacity to resell their unused pipeline capacity rights, called "capacity release," creating a valuable and efficient secondary transportation market. Since then, the Commission has been monitoring the gas transportation and storage of natural gas to ensure the most efficient and effective natural gas delivery infrastructure for consumers. Last year, the Commission, in Order No. 637, revised its open access transportation regulations relating, among other things, to scheduling procedures, capacity segmentation, and pipeline penalties. When these changes are fully implemented, they should give shippers added flexibility to make more efficient use the existing pipeline grid.

As a result of the pro-competitive policies pursued by both the Congress and the Commission, the natural gas commodity market is truly competitive. There are about 8,000 producers operating over 300,000 wells in the United States. In addition, the North American natural gas markets have been integrated, thus permitting an increasing contribution of Canadian gas to meet U.S. market growth, as well as U.S. gas sales to Mexico, increasing markets for U.S. producers. Natural gas buyers in general are no longer limited to buying from one pipeline. Instead, they have a wide range of supply options and various transportation and storage options. In addition, an active financial

market has developed to allow buyers and sellers to hedge against price volatility, depending on their tolerance of risk.

Although different sources quote different numbers, no one disputes that this competition has produced substantial consumer benefits. In addition, reserve prospects for natural gas appear to be very promising. Estimates range from 1,200 trillion cubic feet (Tcf) to 1,700 Tcf, the equivalent of a 55-75 year supply at current and projected requirements. Pro-competitive policies, technological innovation, especially in discovery and drilling techniques, environmental policies, and low prices have led to increased demand for this clean-burning fuel, especially in the electric generation area.

Unfortunately, the other side of this bright picture is that spot wellhead prices for natural gas have roughly tripled since 1999, when natural gas was routinely traded in the \$2.50-3.00 per MMBtu range. While the price increase has focused a lot of attention on the natural gas industry by lawmakers and regulators, I believe the market itself has responded, without any need for new laws or new regulations. Producers of natural gas have already undertaken efforts to increase the supply of natural gas, and the number of active natural gas rigs has more than doubled in the past year and a half. While there is usually a lag bringing this new production on line, the increase in new drilling should help balance supply and demand.

In sum, the operation of the interstate natural gas market appears sound, as evidenced by the dramatic increase in drilling activity in response to market signals.

III. Why are natural gas prices so high this winter?

As explained above, natural gas is now a commodity that is sold in an open market where the laws of supply and demand determine the price. Weather, economic growth and the price for other fuels are all factors that affect the demand for gas. This winter several factors converged at once to produce very high spot natural gas prices.

Demand for natural gas has increased in all sectors over the last decade due to economic growth. In addition, a significant number of new electric generators has come on-line in the last few years that are fueled by natural gas. While these generators produce power in an environmentally friendly way using clean-burning natural gas, they are creating a year-round demand for a commodity that has traditionally been used more in the winter than in the summer. Increased use of gas by electric generators has also affected overall demand in the winter.

Weather is also a factor that affects the demand for natural gas. After much warmer than normal winters in many areas of the country for several years, temperatures in November and December of this past year either were below, or well below, normal in all but five states. This significantly increased the demand for natural gas, as well as other heating fuels, such as propane and fuel oil.

Although the demand for natural gas has grown in recent years, the supply has somewhat lagged behind this demand. After the prices for natural gas and oil collapsed in 1998, producers invested less capital in the exploration and production of natural gas. In January of 1998, there were over 633 drilling rigs in operation. By April of 1999, after

a sustained period of low gas prices, the rig count dropped to 362. While there are plentiful reserves in the ground, maintaining adequate deliverable gas supplies requires a steady drilling program. The reduction in gas drilling reduced supply. This trend was reversed in late 1999. Although there were 905 active drilling rigs on February 16 of this year, historical experience shows there is a time lag (between three months to eighteen months or more) between increased drilling and a significant supply response.

Finally, while spot prices have spiked to \$20 per MMBtu, or even higher in some areas of the country this winter, it is important to understand that local distribution companies and end-users need not, and generally do not, buy all their gas on the spot market. Today's competitive market provides gas purchasers a number of options for achieving greater price stability than is available on the spot market. Gas purchasers can, for example: (1) enter into long-term supply contracts; (2) purchase gas during cheaper, off-peak periods and place it in storage for use during peak periods; (3) forward contract using gas futures; and, (4) purchase financial hedging instruments. Through such strategies, gas purchasers can keep their overall gas costs substantially below spot market levels. For example, in January of this year, when spot market prices at New York City gates rose above \$18 per MMBtu, the overall gas costs of the two major New York local distribution companies, Con Edison and Brooklyn Union, were in the \$8 to \$10 per MMBtu range.

IV. Pipeline Construction

Adequate natural gas pipeline transmission and storage capacity is critical to support the continued functioning of the competitive market for the gas commodity. If that market is to ensure an adequate supply of natural gas at the lowest reasonable cost, all gas sellers must be able to reasonably reach the highest-bidding gas buyers, and all gas buyers must be able to reach the lowest selling producers. For this to continue to occur, it is clear that additional pipeline capacity must be built. As new gas supplies are developed in response to the continued growth in natural gas consumption and increased prices, new pipeline facilities will be necessary to allow those supplies to reach the market.

I pledge my continued support for the construction of new pipeline infrastructure to meet these critical needs, and I will do everything I can to ensure that the Commission processes certificate applications for proposed pipeline projects as quickly as possible.

For example, in response to the present situation in California, the Commission is responding as quickly as possible to any applications to construct new capacity. We are also encouraging applicants to work closely with staff at the earliest stages of project development to expedite the certification process. Early staff involvement may include getting a head start on meetings with stakeholders and the preparation of environmental documents. For the appropriate projects, this may significantly speed the certification process.

In the last seven months, the Commission has issued certificates for three projects, with total capacity of almost 119,000 Mcf/d of capacity, that could benefit the West. Several more certificate applications are pending and the Commission is committed to moving quickly on these projects, too. The Commission is prepared to adopt additional procedures for expedition if they will help to alleviate the present emergency. The Commission is actively pursuing ways to expedite the approval of infrastructure needed to serve California and the West, including raising the current dollar limit on automatic authorizations. This will allow pipelines to construct needed facilities automatically, as long as they comply with environmental regulations.

Of course, any actions the Commission takes to expedite new capacity for gas to serve California and the West can only be effective if there is available local capacity to deliver gas downstream of the interstate pipeline. The availability of sufficient local take-away capacity, however, is a matter that is within the control of states. For example, it appears that the intrastate gas transportation network in southern California is constrained and this may, to some extent, have affected gas prices in that area, which are among the highest in the nation. I urge the State of California to expedite its consideration of proposals to eliminate those constraints and provide relief to California consumers. Pipelines should coordinate their efforts with local distribution companies, public utilities and state officials. The Commission will cooperate with the states in order to ensure that new facilities subject to state jurisdiction are properly integrated with the interstate grid.

Aside from the current situation in California, there is also a critical need to provide transportation for newly developed gas supplies to reach all U.S. markets. For example, the Energy Information Administration (EIA) projects a significant increase in imports of natural gas to the United States from Canada. Delivering that gas to U.S. markets will require increased pipeline capacity.

Another major potential new source of gas is from the Arctic regions, including the North Slope of Alaska. I strongly support the construction of a natural gas pipeline from the North Slope of Alaska to the lower-48 states. The Commission conditionally approved the Alaskan Natural Gas Transportation System (ANGTS) in the late 1970s, pursuant to the Alaska Natural Gas Transportation Act (ANGTA). The U.S. portion of the ANGTS comprises three segments which were issued a conditional certificate by the Commission in December 1977. Originally, the ANGTS was scheduled to be completed by January 1, 1983. However, to date, only the Eastern Leg and a portion of the Western Leg have been constructed and placed in operation.

If constructed, an Alaska pipeline would provide unprecedented economic, energy security, and environmental benefits to the United States by bringing a very large supply of additional gas to the domestic market. It has been estimated that there are at least 26 trillion cubic feet of natural gas in the North Slope of Alaska, which would be a very significant addition to our Nation's energy supply. I am fully committed to acting on requests for the construction of pipeline infrastructure to deliver this gas to North

American consumers. I well understand that the ongoing development of Canadian and Alaskan natural gas supplies is critical to our nation's energy needs and security.

Aside from the above described certificate proceeding, there is currently no application on file with the Commission concerning an Alaska natural gas pipeline. However, under the direction of Chairman Hoecker, the Commission's staff prepared a report reviewing the history of proceedings under the Alaska Natural Gas Transportation Act (ANGTA), including the statutes and relevant orders. I have not yet an opportunity to review that report in detail. As I have already emphasized, my main goal is to ensure the construction of needed pipeline infrastructure to allow new gas supplies to reach market.

V. Conclusion

The recent increases in natural gas prices are a matter of serious concern for gas customers and indeed for the nation as a whole. Nonetheless, natural gas deregulation has been an extremely successful long-term policy and the fundamental structure of natural gas markets remains sound. Beginning in 1984, competition in the natural gas industry has led to fifteen years of prices that were lower than anyone anticipated. In fact, the low prices lasted for so long that it was easy to forget the inherent tendency of energy markets towards boom and bust cycles. The nation's competitive policy has also produced a robust, flexible and responsive natural gas market. Already, producers have responded to higher prices with increased drilling. Increasingly, too, customers are adjusting. For example, we hear of electric generators actively reconsidering their

exclusive reliance on natural gas for new plants. Everyone has a role to play in helping driving demand and supply back into better balance. We at the Commission will do our part to ensure that new pipelines can be built to support a growing industry and that natural gas transportation supports flexible, innovative markets. I am confident that states and other federal agencies will also do their parts to put in place needed infrastructure and to mitigate short-term hardships.

Thank you. I will be happy to answer any questions you may have.